IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1959

No. 513

UNITED STATES OF AMERICA,
Petitioner,

v.

CANNELTON SEWER PIPE COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

SUPPLEMENTAL MEMORANDUM FOR THE RESPONDENT

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I

The Record

There is no dispute as to what the issue is in this case on the merits, if the various arguments now raised by the Government are properly before the Court—on this Record. It is plain, however, that the case now presented to this Court by the Government is very

different from the case which was presented to the District Court.

In the Government's Reply Brief, no reference whatever is made to the Pre-Trial Order of the District Court, approved by counsel for both parties. (R. 263-65; our Main Br. 37-38). This order "controls the subsequent course of the action, unless modified at the trial to prevent manifest injustice." Fed. R. Civ. P. 16. The function of pre-trial is to narrow issues. That function is completely perverted if the Government may nevertheless make wholly new contentions on appeal to the Court of Appeals, and again on appeal to this Court. If allowed, the result would be unfair to the other party who appropriately relies on the Pre-Trial Order in building the Record which is reviewed on appeal.

In its Reply Brief (pp. 3-4), the Government now for the first time specifically attacks two of the Findings of Fact, Nos. 13 and 10 (R. 5), but no exception was taken to these findings in the trial court, nor in the Court of Appeals. The Government does not now question Finding 12 (R. 5) that "There was no market for the fire clay and shale mined by plaintiff" before it was processed into burnt clay products.

The Government's shift appears most strikingly in its contention now presented for the first time in its Reply Brief (pp. 42-43) that the case should now be remanded to the District Court to be decided on the basis of the "proportionate profits" test. As we pointed out in our main brief (p. 112), in the District Court counsel for the Government expressly disclaimed this test, saying that it had been "abrogated"

and "abandoned." The Government now says (Reply Br. 42 n. 55) that this was done "erroneously." But he was the Government's counsel, and his statements shaped the issues before the District Court. The Government should not be allowed to blow cold in the District Court and hot here. It is clearly seeking a second day in court. *Cf. Galt* v. *Commissioner,* 216 F.2d 41, 51 (7th Cir. 1954).

II

Meaning of Commercially Marketable Mineral Product or Products

In our Main Brief (pp. 41-42), we pointed out that the Government was giving an artificial meaning to the key phrase "commercially marketable mineral product or products," and that in effect the Government was writing the term out of the statute. We gave nine references to the Government's original brief (pp. 18, 21, 25, 26, 76, 78, 80, 85, 90) where the Government interpreted the statutory language "commercially marketable" as meaning simply "fit for commercial or industrial use." We demonstrated that the statutory language could not possibly be the equivalent of the Government's substituted term; and that term is not mentioned once in the Government's 45 page reply brief.

Having been driven from an untenable position as to the meaning of "commercially marketable mineral product or products," the Government now seeks, in its reply brief, to substitute other labels for the statutory term. It is hard to find just where the Government now stands, but its reply brief equates "commercially

marketable mineral product or products" with "the commercially valuable constituent of the mine" (pp. 3, 12) and also with the "commercially valuable constituent of the deposit." (p. 11) In Heading II (p. 8) the Government says that the "cutoff" is the "basic mineral product fit for sale or commercial use," and in another place (p. 11) the Government treats the "cutoff" as "that initial point where [the mineral] was in a condition fit for sale or use." Such references to "sale" may appear to give some effect to the concept of marketability, but the use of the disjunctive shows that even the element of saleability would not be necessary to satisfy the Government's latest understanding of "commercially marketable mineral product or products."

The Government's latest phrases have about the same meaning as "gross value at the mine," which are the words used by Congress in 1913, and never since. What Congress did say in the statute now before the Court is "commercially marketable mineral product or products," and all of the Government's phrases—the new ones as well as the old ones—have the simple effect of writing those words out of the statute.

In our Main Brief (pp. 106-107), we pointed out that after the Government lost two cases in which it contended that "commercially marketable" meant "ready for use in manufacture" the Government turned its attention to "mineral product" and argued that a "manufactured" product cannot be a "mineral" product. The Government's argument to that effect was made primarily in the *Dragon Cement*

case in the First Circuit, although it was also made in the *Sapulpa* case in the Tenth Circuit and the *Merry Brothers* case in the Fifth Circuit (our Main Br. 107 & n.5). In the Government's reply brief here (pp. 15-16), there is an apparent attempt to make some use of this old argument based on the concept of "a mineral product," although the Government does not now make the argument as squarely and directly as it presented it to the First Circuit in the *Dragon Cement* case. This whole line of argument was carefully considered and rejected by the First Circuit in that case (Resp. App. II, pp. 23-26) and by the Courts of Appeals in the *Sapulpa* and *Merry Brothers* cases; and it was expressly disclaimed by the Government's counsel in this case in the District Court.[1]

Under Point II(D) of our original brief (pp. 71-76), we argued that even if the "commercially marketable mineral product or products" are to be determined on an industry-wide basis, the judgment should be affirmed since miners of fire clay and shale normally

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[1] In the Government's Pre-Trial Brief in the District Court, it said (p. 6):

> "All the courts rejected this theory and held that what Congress had said was clear and unambiguous and that there was no justification within the statute to restrict the allowance for depletion to a percentage of mining income as distinguished from manufacturing income. [Citing Dragon Cement and Merry Brothers.]
>
> "This case arose because the Internal Revenue Service computed the taxpayer's allowance for depletion on the basis of a proration of profit to the purely mining operation costs. Following the denial of certiorari by the Supreme Court in the *Dragon Cement* and *Merry Brothers* cases, *supra*, the Internal Revenue Service abandoned this theory of computation . . ."

are required to process such minerals into burnt clay products (such as sewer pipe) to make them commercially marketable. The Government gives no answer to this argument in its reply brief. Indeed, in its Reply Brief (pp. 5-6), the Government now withdraws its reliance on the Bureau of Mines' figures, which show, among other things, that *most of the fire clay and shale produced in the country is processed by the miners into burnt clay products.* There is no basis on which the Government can properly deny that the processes which the Cannelton Company applies to its fire clay and shale (crushing, grinding, tempering, shaping, drying, and firing in a kiln) are the ordinary treatment processes *normally* applied by fire clay and shale mine owners and operators in order to obtain the commercially marketable mineral product or products.

III

Legislative History

The Government asserts (Reply Br. 27) that our discussion of the legislative history "fails to meet" the Government's "thesis" that "Congress expressed its determination to establish a cutoff at the point where the basic mineral product is obtainable, and thus to avoid preference of the integrated miner over the non-integrated miner."

What our discussion of the legislative history (Main Br. 76-105) shows is that Congress has always intended that the commercially marketable products rule be used to determine the depletion base and that it has never been concerned with whether a particular proc-

ess may technically convert a "commercially valuable mineral constituent into a new and different product" (Reply Br. 27)—whatever this may mean. Congress has been interested only in whether the process is one normally applied to produce the mine owner's commercially marketable product or products. Our discussion also shows, contrary to the Government's assertion, that Congress has recognized that various miners of the same ore or mineral may have different commercially marketable products. It has recognized this in the case of gold and copper ores, for example, as we stated in our original brief; the error in the Government's attempt to show the contrary is explained in the Appendix to this memorandum (pp. 15-20). Congress has also recognized this in the case of coal, as shown in our original brief; the Government does not even attempt to refute this fact as to coal, but only says (Reply Br. 26 n. 32) that, "In various respects, coal has been the subject of individual consideration by Congress."

To support its position that Congress undertook to provide "an industry-wide cutoff," the Government refers (Reply Br. 28-34) to the Treasury's 1932 regulations and statements by representatives of the mining industry that originally the Treasury, under those regulations, had considered processes such as cyanidation as "equivalent" to concentration. Thus, the Government argues (Reply Br. 28) that Congress wrote Section 114(b)(4)(B) only to insure that those concentration processes would be included in mining "to assure substantial equivalence, not in order to permit

significant variation." It is obvious, however, that cyanidation and leaching as allowed by the statute go beyond concentration as allowed to miners of gold and copper ores who do not apply these processes. As we pointed out in our Main Brief (p. 88), the Treasury justified its practice, begun about 1940, of disallowing these processes on the basis of achieving equality. Now the Government says that Congress reversed this practice by the statute in order to *assure* equality!

The Government also seeks to show (Reply Br. 33-34) the similarity of the 1932 regulations to the statute by setting forth the lists of processes in each. On their face, they show differences, in that the statute lists processes required to make certain types of ores marketable which the regulation did not mention.[2] The Government completely ignores the material before the lists of processes which, as we have shown (at p. 90 of our Main Brief), is entirely different in the regulation and in the statute—and which, as the Government has said (Main Br. 26-27), is the "crucial" part of the statute to be interpreted and applied in this case.

The significant point about the legislative history of

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[2] Thus, sintering is listed in clause (iii) of the statute but is not in the regulation. A number of processes are listed in clause (iv) of the statute that do not appear in the regulation.

The Government takes comfort (Reply Br. 33 n. 44) from the *amicus curiae* brief of the National Coal Association which it says states that the statute "closely parallels" the regulation. This statement, however, is merely quoted from a Treasury statement and is quoted only in support of the *amicus* brief's position as to coal. Since the regulation allowed the processes required to make coal marketable, it is not surprising that the statute lists the same processes.

the 1943 statute is this. It is clear that representatives of the mining industry sought the commercially marketable products rule and that Congress adopted this rule by including in "mining" the "ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products."

Turning to the period 1943 to 1951, the Government states (Reply Br. 34) that "taxpayer offers nothing which has bearing on the construction of the statute." We did, however, discuss (at pp. 92-93 of our Main Brief) the only change in that period having any significance, *i.e.*, the addition of "transportation" to the definition of "mining" in 1950 in order to negate a Treasury attempt to modify the commercially marketable products rule.[3] We also (at pp. 95-96 of our Main Brief) exposed an error in the Government's statement of a bit of legislative history in 1949.

The Government also seeks (Reply Br. 35-38) to minimize the fact that, since 1954, Congress has re-

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[3] The Government also states (Reply Br. 17) that our failure to discuss its chart (Gov't App. B, following p. 500) as to "products in relation to which various branches of mining industry sought percentage depletion" shows that "taxpayer has been unable to find a single flaw in this documentation." Actually, the chart is incomplete; quicksilver ores, for example, are omitted. Also, it is not shown that the talc industry sought "fine pulverization" which the Treasury had disallowed as a manufacturing process. House Hearings, 1953, pp. 2035-37, 2041-42 (Gov't App. B, pp. 448-51).

The testimony outlined as to fire clay is discussed in our Main brief (p. 93 n. 45). The testimony outlined as to shale (presented after shale had been granted percentage depletion) involves only a request that the rate for shale be increased and does not relate to the products in relation to which percentage depletion was sought.

In a further effort to show the products in relation to which mineral producers have sought percentage depletion, the Govern-

fused to act on three Treasury attempts to modify or abolish the commercially marketable products rule. It seeks comfort (Reply Br. 36) from the fact that Congress in 1958 held no hearings and "gave no intimation of its views." Does a failure even to hold hearings on a Treasury recommendation give no intimation of Congress' views on the importance of the proposal or the need for legislation in the area? In 1959, hearings were held and the Government states (Reply Br. 36) that "a great variety of views [were] expressed." The Government, instead of discussing the views of members of the Ways and Means Committee, critical of the Treasury's position (Resp. Br. 102-03), quotes at length (Reply Br. 36-37 n. 48) the representative of the American Mining Congress, a group composed primarily of metal mining interests which does not represent the producers of fire clay or shale. All the Government says about the reaction of the Committee is that it "did not write a report" and that it announced, in January, 1960, that it would defer further action until the Court decides this case (Reply Br. 37). Yet the Hearings were held in March, 1959, nine months before this latest announcement. The failure of the Committee to act after the March hearings during the 1959 Session, coupled with the views of Committee members as expressed at the Hearings, hardly shows that the Committee was impressed with the Treasury's criticism of the present law and its proposal to change the law.

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ment cites (Reply Br. 35 n. 46) anonymous articles in the *Brick and Clay Record*, and it indicates that this magazine speaks for the "structural clay products industry." This magazine is a commercial journal; it does not speak for this industry or any segment of it.

IV

Application of the Statute

The Government asserts (Reply Br. 40, Heading III) that "the statute may be readily and consistently applied" under its construction, but it fails to explain how this is so. As far as this case is concerned, it merely says (Reply Br. 42) that the regulation, including the part which Government counsel in the District Court described as "abrogated" and "abandoned" (our Main Br. 112), should be applied. It describes the regulation, but takes no position as to *how* it should be applied here or how the problems in applying it, discussed in our Main Brief (pp. 110-12), should be solved. It prefers to take up these matters in the District Court at a second trial (Reply Br. 42-43).

In our Main Brief (p. 116 and p. 69 n. 22) we explained the facts concerning L. R. Chapman who dug and delivered clay in Kentucky in 1951 for a sewer pipe producer who owned the clay land. We pointed out that Chapman was entitled to no percentage depletion because he did not have an economic interest in the land and that, contrary to the Government's contention, the decision below did not discriminate against him by giving taxpayer a depletion deduction computed on the selling price of its sewer pipe.[4]

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[4] In its original brief (p. 83 n. 83), the Government referred to Chapman as a "miner" in Kentucky who "sold substantial quantities of both fire clay and shale to a sewer pipe manufacturer." We explained in our brief that this "miner" did not "sell" fire clay or shale, but merely performed services in digging and delivering fire clay and shale for the land owner. Now the Government merely

The Government now refers (Reply Br. 10 n. 5) to the fact that, in 1957, taxpayer began to obtain its clay from land leased from Chapman which Chapman digs and delivers to it.[5] It states that this arrangement "documents the proposition that non-integrated miners will not survive if integrated miners may completely pervert the depletion allowance." Actually, lessees with an economic interest have always been entitled to a depletion deduction based on their gross income from the property less the royalties paid (as to which the lessor is entitled to a depletion deduction). How does this pervert the depletion allowance? Chapman, by leasing this land to taxpayer, has gained new digging and hauling business. Assuming he is a "non-integrated" miner, how does the fact that taxpayer's lease gives him additional business show that he cannot "survive"?

V

The 54 Cases

The Government refers to our statement that "the Government's position in this litigation is inconsistent with some 54 cases," and states that the listing of these cases is "indiscriminate," because they involve "various issues." (Reply Br. 38). Actually, as any study

states (Reply Br. 3 n. 1) that he "mined" fire clay and shale (although still stating, Reply Br. 5, that his operations in Kentucky established a "regular and substantial commerce in raw fire clay and shale").

[5] The Government states that taxpayer has leased this land for one dollar. Actually, the lease calls for a consideration of one dollar *plus a royalty per ton* (R. 179), as is common in mineral leases. Taxpayer turned to this source of clay in 1957, at a time when the costs of its underground mine were increasing (R. 68), and after looking for 5 years in both Kentucky and Indiana for a new source of clay. (R. 69-70).

cf these cases will show, each has involved the question of determining what are "the commercially marketable mineral product or products"—the issue which the Government very correctly states (Reply Br. 8) is presented here on the merits. The Government complains (Reply Br. 38) because cases involving the "*Merry Brothers* rule" are included.[6] Yet in its original brief (pp. 18-19, 90-91), the Government twice specifically invited this Court to overrule those cases. It also complains (Reply Br. 39-40) because some of the cases involved "whether a particular process was or was not one required in order to put the mineral in marketable condition . . ." Yet in all of these cases, the Government tried to exclude those particular processes from "mining" on the basis of one or more of the arguments it presents here.

The Government also complains (Reply Br. 38 n. 50, 38-39) because we omitted oil and gas cases and *Alabama By-Products Corp.* v. *United States*, 258 F. 2d 892 (5th Cir. 1958), *cert. denied*, 358 U. S. 930 (1959). The oil and gas cases were omitted because they did

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[6] Elsewhere (Reply Br. 14), in attempting to distinguish the *Merry Brothers* case, the Government says that case "took the view that the total absence of sales of brick clay (as was assumed on the pleadings) enabled producers of that mineral to take brick as the basis of depletion." No such thing was "assumed on the pleadings." The parties in that case entered a stipulation showing what sales there are of brick and tile clay in the country. These sales were small percentage-wise and the court considered them negligible, but it is not true that there was a "total absence" of sales. Furthermore, the record shows that Merry Brothers itself sold a small amount of its own clay for purposes other than making brick and tile. Merry Bros. Brick and Tile Co., 145 F. Supp. 186, 187, 189 (S. D. Ga. 1956), *aff'd*, 242 F. 2d 708 (5th Cir. 1957), *cert. denied*, 355 U. S. 824 (1957).

not involve in any way the interpretation of Section 114(b)(4)(B), the provision here involved, which is not even applicable to oil and gas. *Alabama By-Products* was omitted because it too did not involve the interpretation of Section 114(b)(4)(B) or the determination of the "commercially marketable mineral product or products" of coal. There the taxpayer conceded that its coal was commercially marketable and the only issue was whether its depletion deduction should be computed on the basis of a "representative market or field price" or by use of the proportionate profits method. The case merely held that "taxpayer has failed to meet its burden of proving that there was no representative market or field price for its coals." 258 F. 2d at 900.[7]

Respectfully submitted,

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[7] The Government also misstates (Reply Br. 39) how such price was determined. It says that taxpayer's sales "did not establish the value of the coal because the sales were 'forced' sales" and that the court held "that the value of taxpayer's coal was to be computed by reference to the representative market price for coal of like kind and grade." Actually, the price used was that at which taxpayer sold its coal. This was the figure used on its return. 258 F. 2d at 895. Taxpayer, by an amended complaint, filed after the trial, sought to raise the issue that the market or field price, if one existed, was higher than such price at which it sold. 258 F. 2d. at 895. The court held, however, that such issue was not raised by the claim for refund and refused to consider it. 258 F. 2d at 900-01.

APPENDIX

Treatment Processes

The Government has great difficulty in attempting to answer our argument that Congress has recognized that "the commercially marketable mineral product or products" may be different for miners of the same mineral, as shown by the nature of certain processes expressly listed in the statute as included in or excluded from "ordinary treatment processes." (Resp. Br. 62-63; Resp. App. II, pp. 8-11). The Government concedes (as it must), although somewhat indirectly and in a footnote (Reply Br. 26 n. 32), that Congress has included as "ordinary treatment processes" in the case of coal certain processes which are not always necessary to make coal marketable; it says somewhat lamely (and inconsistently with its stress in its main brief on Congress' penchant for uniformity under the percentage depletion statute) that, "In various respects, coal has been the subject of individual consideration by Congress." (Gov't Reply Br. 26 n. 32).

The Government also concedes that cyanidation, specifically included by the statute as an "ordinary treatment process," yields gold bullion and that this is a different and more processed product than the gold ore concentrate which is the commercially marketable product in the case of gold ore which is smelted. (Gov't Reply Br. 21-22). It seeks to avoid the effect of this necessary concession by contending that Congress never intended to permit the inclusion in "ordinary treatment processes" of the last step in the cyanidation process, in which the gold precipitate is

melted down into bars of bullion and ordinarily with the addition of a flux such as borax.[1] This last step, the Government contends, is not allowable because it goes beyond "beneficiation," which it says is virtually synonymous with "concentration." (Gov't Reply Br. 22-23). It points out that the pre-1943 Treasury Regulations allowed, in the case of metallic ores, "other processes to the extent to which they do not beneficiate the product in greater degree . . . than crushing and concentrating (by gravity or flotation)." (Gov't Reply Br. 23). But the Government ignores two very important things.

First, the definition of "gross income from the property" enacted by Congress in 1943 did *not* adopt the above-quoted restrictive language from the pre-1943 Regulations. Instead, with that language before it, Congress deliberately chose to include in "ordinary treatment processes," in the case of gold and other metallic ores not customarily sold in the form of the crude mineral product, "beneficiation by concentration (gravity, flotation, amalgamation, electrostatic, or magnetic), cyanidation, leaching, crystallization, precipitation . . . or by substantially equivalent processes or combination of processes used in the separation or extraction of the product or products from the ore, including the furnacing of quicksilver ores."

Second, the Government's present argument with respect to the cyanidation of gold is simply contrary

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[1] TAGGART, HANDBOOK OF ORE DRESSING 961 (1927 ed.).

to the way the 1943 statute has always been administered by the Treasury Department.[2]

In its discussion of leaching in its reply brief (pp. 24-25), the Government seeks to avoid our point that leaching yields a different product than copper ore concentrate by arguing that, unless electrolytic deposition (a disallowed process) is used to precipitate the leaching solution, the precipitate must be "sent to the smelter." (Gov't Reply Br. 25). In failing to explain what is done to the precipitate at the smelter, the Government leaves the impression that the leaching precipitate is the equivalent of the copper ore concentrate. This is not correct. The impure copper precipitated by chemical means must be *refined* (a process which is also necessary *after smelting* of ore concentrate), and this may be done "at a smelter," but if the precipitate is subjected to any process which might be considered smelting, it is usually only *converting*, the final stage in the smelting process used for copper ore concentrates.[3]

Aware of its difficulties with cyanidation and leaching, the Government argues that there is a "great gap

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[2] For example, Lincoln Arnold, Chairman, Tax Committee, American Mining Congress, whom the Government quotes extensively in its reply brief (p. 36 n. 48), in the same statement says that "the processes after cyanidation of gold ores in producing the Dore bar" are "recognized as allowable processes under long-standing administrative decisions and practices." House Hearings, 1959, p. 71.

[3] U. S. Bureau of Mines, Dep't of Interior, Materials Survey: Copper, c. II, at 57-58, 25, 34, 46, c. VI, at 21 n.b. (1952); Stoughton and Butts, Engineering Metallurgy 103-104, 301 (1926). Converting is not treated by some authorities as a part of smelting. Stoughton and Butts, *op. cit. supra*, at 92-93.

between the proposition that different processes may result in variation in the purity of minerals extracted and the proposition . . . that a taxpayer, having obtained the valuable constituent of the mineral, may proceed to include further processing employed in order to convert the first valuable product into a new and different one." (Gov't Reply Br. 21). Thus, the Government returns, in substance, to its mining-manufacturing distinction, which it claims not to assert at all, and which it expressly disclaimed in the District Court.

Faced with the argument that many of the included processes listed in the statute involve physical or chemical changes in the mineral, or both, the Government now says (Reply Br. 11, 19) that it is not saying that Congress attempted to draw a line between mining and manufacturing. And yet it still relies upon the argument that " 'Ordinary treatment processes normally applied by mine owners or operators' can hardly be taken to contemplate the inclusion of processes which a mine owner could never normally apply unless he also happened to be something else in addition, *i.e.*, a fabricator or manufacturer." (Gov't Reply Br. 11). It attempts to rationalize this logical inconsistency in its argument by explaining that it simply cannot believe that manufacturing processes are normally applied by mine owners in order to obtain "the valuable constituent of a mine." Therefore, it argues, "manufacturing processes are, as a practical matter, excluded." (Gov't Reply Br. 11-12). It seeks to explain, indirectly, the express inclusion by Congress of such metallurgical processes as cyanidation, leaching,

and the furnacing of quicksilver ores, by saying (Reply Br. 19 & n. 15) that "extractive processes" (even the excluded processes of smelting and refining) are "certainly not manufacturing." The Government has another name for such processes; they "are ordinarily classified as metallurgy." The idea seems to be that metal miners who have to change the crude mineral physically and chemically by complex metallurgical processes to obtain a commercially marketable product are engaged in "ordinary treatment processes" because their manufacturing has a special name, metallurgy; whereas, a clay miner who has to grind and burn his clay in order to sell it has passed over the line and done something which is "fabrication" or "manufacturing" and not "mining" because, even though he could not sell it, he already had "something of value." (Gov't Reply Br. 19).

It is not true, as the Government suggests, that "the only situation in which taxpayer would give effect to the words 'ordinary treatment processes' is where a taxpayer, having obtained one product which he could sell at a profit, proceeds to go further in order to obtain a still more valuable product." (Gov't Reply Br. 18 n. 14). As explained in our main brief (p. 57), we recognize that the words "ordinary" and "normally" and the plural reference to "mine owners or operators" restrict "mining" in the case of this taxpayer to those processes actually applied to obtain its commercially marketable products which are the *ordinary* treatment processes *normally* applied *by mine owners or operators* in order to obtain those products. Furthermore, as

pointed out in our main brief (pp. 71-76), even if the words of the statute should be construed as implying an industry-wide test, the question would be what processes mine operators *normally* and *usually* apply to obtain their commercially marketable products, not, as the Government contends, what processes are "normal for miners, *qua* miners." (Gov't Br. 8).

SUPREME COURT OF THE UNITED STATES

No. 513.—October Term, 1959.

United States of America, Petitioner, *v.* Cannelton Sewer Pipe Company.	On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit.

[June 27, 1960.]

Mr. Justice Clark delivered the opinion of the Court.

This income tax refund suit involves the statutory percentage depletion allowance to which respondent, an integrated miner-manufacturer of burnt clay products from fire clay and shale, is entitled under the Internal Revenue Code of 1939.[1]

The percentage granted by the statute is on respondent's "gross income from mining." It defines "mining" to include the "ordinary treatment processes normally applied by mine owners . . . to obtain the commercially marketable mineral product or products." Respondent claimed that its first "commercially marketable mineral product" is sewer pipe and other vitrified articles. Alternatively, it contended that depletion should be based on the price of 80 tons of ground fire clay and shale actually sold during the tax year in question. The District Court agreed with respondent's first claim. The Court of Appeals affirmed, holding that respondent could not profitably sell its raw fire clay and shale without processing it into finished products, and that its statutory percentage depletion was therefore properly based on its gross sales

[1] The applicable provisions of the Code are § 23 (m) and § 114 (b)(4). In general, they provide for a depletion allowance based on a percentage of "gross income from mining," which is specifically defined. See note 8, *infra*. The percentage permitted on shale is 5%, and on fire clay, 15%.

of the latter. 268 F. 2d 334. The Government contends that the product from which "gross income from mining" is computed is an industry-wide test and cannot be reduced to a particular operation that a taxpayer might find profitable. The Government further argues that, while the statute permits ordinary treatment processes normally applied by miners to the raw product of their mines to produce a commercially marketable mineral product, it does not embrace the fabrication of the mineral product into finished articles. In view of the importance of the question to taxpayers as well as to the Government, we granted certiorari. 361 U. S. 923. We disagree with respondent's contention that the issue is not presented by this record, and we therefore reach the merits. We have concluded that, under the mandate of the statute, respondent's "gross income from mining" under the findings here is the value of its raw fire clay and shale, after the application of the ordinary treatment processes normally applied by nonintegrated miners engaged in the recovery of those minerals.[2]

I.

During the tax year ending November 30, 1951, the respondent owned and operated an underground mine from which it produced fire clay and shale in proportions of 60% fire clay and 40% shale. It transported the raw mineral product by truck to its plant at Cannelton, Indiana, about one and one-half miles distant. There it processed and fabricated the fire clay and shale into vitrified sewer pipe, flue lining and related products. In this process, the clay and shale is first ground into a pulverized form about as fine as talcum powder. The

[2] The quantity of ground and bagged fire clay and shale actually sold is too negligible to furnish an appropriate basis for computing depletion.

powder is then mixed with water in a pug mill and becomes a plastic mass, which is formed by machines into the shape of the finished ware desired. The ware is then placed in dryers where heat of less than 212° is applied to remove all of the water. This process takes from 12 hours to 3 weeks, depending on the size of the ware. Thereafter the ware is vitrified in kilns at 2,200° Fahrenheit, requiring from 60 to 210 hours. It is then cooled, graded and either shipped or stored.

Not all clays and shales are suitable for respondent's operations. They must have plasticity, special drying qualities and be able to withstand high temperatures. Respondent's clay, known as Cannelton clay, is the deepest clay mined in Indiana and, respondent says, yields the best sewer pipe. Its cost of removing and delivering the same to its plant was $2.418 per ton in 1951. Respondent used some 38,473 tons of clay and shale in its operations that year and sold approximately 80 tons of ground fire clay and shale in bags at a price of $22.88 per ton. Net sales of its finished wares amounted to approximately one and a half million dollars.

In connection with its tax assessment for the year in question, respondent filed a document in which it stated that "we used as a basis for calculating the gross income from our mining operations of shale and fire clay the point in our manufacturing operations at which we first arrive with a commercially marketable product, which is ground fire clay. This product arrives after the raw mineral is crushed and granulated to such extent that by the addition of water it can be made into a mortar for use in laying or setting fire or refractory brick. This ground fire clay has a definite market and an ascertainable market value at any particular time and is the same product from which our end product, sewer tile, is made simply by the addition of water and the necessary baking process." In this return it based the value of the ground

fire clay at $22.81 per ton, the price for which it sold some 80 tons of that material in bags during 1951. At this figure the depletion allowance would have been slightly above $2 per ton. Thereafter respondent claimed error and asserted that its mineral product, rather than being commercially marketable when it reached the stage of ground fire clay, only became commercially marketable when it became a finished product, *i. e.*, sewer pipe. On this basis, the depletion allowance on petitioner's gross income would be approximately $4 per ton, since the mineral would have a value of about $40 per ton. On the other hand, if the mineral it used in 1951 was valued at $1.60 to $1.90 per ton, the going price elsewhere in Indiana, the depletion allowance would be approximately 20¢ per ton.

The record shows and the District Court found that in 1951 there were substantial sales of raw fire clay and shale in Indiana, mostly in the vicinity of Brazil, about 140 miles from Cannelton. The average price there was $1.60 to $1.90 per ton for fire clay and $1 per ton for shale. Transportation costs from Brazil to Cannelton ran from $4.58 to $5.50 per ton. In Kentucky, across the river from respondent's plant, it appears that fire clay and shale of the same grade were mined and sold [3] before dur-

[3] The evidence indicates that, for $50, Owensboro Sewer Pipe Company bought from L. R. Chapman five acres of ground under which the shale and clay deposits lay. Contemporaneously it made a contract with L. R. Chapman, Inc., to mine and deliver shale and fire clay from this tract to the Owensboro plant for $1.40 per ton. Chapman also testified that in addition he furnished shale and fire clay to other manufacturers in the same area in Kentucky. The arrangements varied. Some were similar to the Owensboro agreement, while others were leases on a royalty basis with a contemporaneous agreement to mine and deliver the clay at a set price. The exact year or years are not clear, but appear to have been between 1949 and 1956. Respondent began using shale and fire clay from the same source by lease arrangement in 1957. The reason for lease arrangements and

ing and subsequent to 1951. In fact, since 1957 respondent has secured all of its mineral requirements from this source on a lease basis under which the lessor mines and delivers the raw material to its plant. The exact cost is not shown, but the haul in 1957 from pit to plant, including the ferry crossing, was some seven miles.

II.

We have carefully studied the legislative history of the depletion allowance, including the voluminous materials furnished by the parties, not only in their briefs but in the exhaustive appendices and the record.[4] We shall not burden this opinion with its repetition.

In summary, mineral depletion for tax purposes is an allowance from income for the exhaustion of capital assets. *Anderson* v. *Helvering*, 310 U. S. 404 (1940). In addition, it is based on the belief that its allowance encourages extensive exploration and increasing discoveries of additional minerals to the benefit of the economy and strength of the Nation. We are not concerned with the validity of this theory or with the statutory policy. Our sole function is application of the congressional mandate. A study of the materials indicates that percentage depletion first came into the tax structure in 1926, when the Congress granted it to oil and gas producers. The percentage allowed was based on "gross income from the property," which was described as "the gross receipts from the sale of oil and gas as it is delivered from the property." Preliminary Report, Joint Committee on Internal Revenue Taxation, Vol. I, Part 2 (1927). The report continued that, as to the integrated

paper transfer of title is not shown. However, Chapman testified that the manufacturers "didn't seem to want to do the prospecting or the sampling until they were sure they could get either a lease or a deed."

[4] The briefs cover 294 pages and the appendices an additional 685, not including 10 charts. The record is 276 pages.

operator, "the gross income from the property must be computed from the production and posted price of oil, as the gross receipts from a refined and transported product can not be used in determining the income as relating to an individual tract or lease." The Treasury Regulations confirmed this understanding. Treas. Reg. 74 (1929 ed.), Arts. 221 (i), 241.

Thereafter, in 1932, percentage depletion was extended to metal mines, coal, and sulphur. The mining engineer of the Joint Committee, Alex R. Shepherd, urged in a report to the Congress [5] that depletion for metal mines be computed, as in the oil and gas industry, on a percentage-of-income basis, and the Revenue Act of 1932 was so drawn. The Shepherd Report pointed out that the percentage basis for oil and gas depletion had been in force for over a year and had "functioned satisfactorily both from economical and administrative viewpoints and without loss of revenue." It added that "careful study of this method as applied to metal mines indicates that the same results will be attained in practice as in the case of oil and gas," but that, because of varied practices in the mining industry, it would be necessary to determine "the point in accounting at which" gross income from the property mined could be calculated. It recommended that "it is logical to peg 'gross income from the property' f. o. b. cars at mine," *i. e.*, net smelter returns, recognizing that processing beyond this point should not be included in calculating "gross income from the property." While as to certain metals, *viz.*, gold, silver, or copper, the report suggested that gross income should be based on receipts from "the sale of the crude, partially beneficiated or refined" product, this was but to make

[5] Preliminary Report on Depletion, Staff Report to the Joint Committee on Internal Revenue Taxation (1930), Appendix XXXI (Shepherd Report).

provision for the specific operations of miners in those metals. In this regard the report also proposed that the depletion base "in the case of all other metals, coal and oil and gas, [should be] the competitive market receipts, or its equivalent, received from the sale of the crude products, or concentrates on an f. o. b. mine, mill, or well basis."

The Congress in fashioning the 1932 Act took into account these recommendations of the industry. It incorporated a provision in the Act allowing percentage depletion for coal and metal mines and sulphur, based on the "gross income from the property." § 114 (b)(4), Revenue Act of 1932, 47 Stat. 169. On the following February 10, 1933, the Treasury issued its Regulation 77, which defined "gross income from the property" as "the amount for which the taxpayer sells (a) the crude mineral product or (b) the product derived therefrom, not to exceed in the case of (a) the representative market or field price . . . or in the case of (b) the representative market or field price . . . of a product of like kind and grade from which the product sold was derived, before the application of any processes . . . with the exception of the processes listed. . . ." Treas. Reg. 77, Art. 221 (g). These exceptions listed processes normally in use in the mining industry for preparing the mineral as a marketable shipping product. The regulation was of unquestioned validity and, in 1943, at the instance of the industry, the Congress substantially embodied it into the statute itself, 58 Stat. 21, 44, including the basic definition of the term "gross income from the property."[6] Since that time the

[6] See, *e. g.*, Hearings before Senate Committee on Finance on H. R. 3687, 78th Cong., 1st Sess. 528; S. Rep. No. 627, 78th Cong., 1st Sess. 23–24; Hearings before House Committee on Ways and Means on Revenue Revisions, 80th Cong., 1st Sess., part 3, at 1857; Hearings before Senate Committee on Finance on H. R. 8920, 81st Cong., 2d Sess. 771; S. Rep. No. 2375, 81st Cong., 2d Sess. 52–53.

section on percentage depletion—§ 114 (b)(4)(B) of the 1939 Code—has remained basically the same.[7] Additional minerals have been added from time to time—shale and fire clay in 1951—until practically all minerals are included.

As now enacted, the section provides that "mining" includes "not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products," plus transportation from the place of extraction to the "plants or mills in which the ordinary treatment processes are applied thereto," not exceeding 50 miles.[8] It then defines "ordinary treatment processes"

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[7] The present statute, § 613 of the Internal Revenue Code of 1954, is essentially unchanged.

[8] Internal Revenue Code of 1939, § 114 (b)(4)(B):

"*Definition of Gross Income from Property.*—As used in this paragraph the term 'gross income from the property' means the gross income from mining. The term 'mining' as used herein shall be considered to include not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products, and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which the ordinary treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills. The term 'ordinary treatment processes,' as used herein, shall include the following: (i) In the case of coal—cleaning, breaking, sizing, and loading for shipment; (ii) in the case of sulphur—pumping to vats, cooling, breaking, and loading for shipment; (iii) in the case of iron ore, bauxite, ball and sagger clay, rock asphalt, and minerals which are customarily sold in the form of a crude mineral product—sorting, concentrating, and sintering to bring to shipping grade and form, and loading for shipment; and (iv) in the case of lead, zinc, copper, gold, silver, or fluorspar ores, potash, and ores which are not customarily

by setting out specifically in four categories those covering some 17 named minerals. Fire clay and shale are not within these specific enumerations. The Government, however, contends that they should come within clause (iii) of the section, which provides that, "in the case of iron ore, bauxite, ball and sagger clay, rock asphalt *and minerals which are customarily sold in the form of a crude mineral product*—sorting, concentrating, and sintering to bring to shipping grade and form, and loading for shipment . . ." are included in "ordinary treatment processes." (Italics added.) Clause (iv) lists specific metals such as lead, zinc, copper, etc., "and ores which are not customarily sold in the form of crude mineral product," and specifically excludes from the permissible processes certain ones used in connection with these metals. To recapitulate, the section contains four categories of dealing with "ordinary treatment processes": the first enumerating those permissible as to the mining of coal; the second, as to sulphur; the third, as to minerals customarily sold in the form of the crude mineral product; and the fourth, as to those minerals not customarily so sold. We note that the Congress even states the steps in each permissible process, and in addition specifically declares some processes not to be "ordinary treatment" ones, *viz.*, "electrolytic deposition, roasting, thermal or electric smelting, or refining." Furthermore, none of the permissible

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sold in the form of crude mineral product—crushing, grinding, and beneficiation by concentration (gravity, flotation, amalgamation, electrostatic, or magnetic), cyanidation, leaching, crystallization, precipitation (but not including as an ordinary treatment process electrolytic deposition, roasting, thermal or electric smelting, or refining) or by substantially equivalent processes or combination of processes used in the separation or extraction of the product or products from the ore, including the furnacing of quicksilver ores. The principles of this subparagraph shall also be applicable in determining gross income attributable to mining for the purposes of section 450 and 453." 26 U. S. C. (1952 ed.) § 114.

processes destroy the physical or chemical identity of the minerals or permit them to be transformed into new products.

From this legislative history, we conclude that Congress intended to grant miners a depletion allowance based on the constructive income from the raw mineral product if marketable in that form, and not on the value of the finished articles.

III.

The findings are that three-fifths of the fire clay produced in Indiana in 1951 was sold in its raw state. This indicates a substantial market for the raw mineral. In addition, large sales of raw fire clay and shale were made across the river in Kentucky. This indicates that fire clay and shale were "commercially marketable" in their raw state unless that phrase also implies marketability at a profit. We believe it does not. Proof of these sales is significant not because it reveals an ability to sell profitably—which the respondent could not do—but because the substantial tonnage being sold in a raw state provides conclusive proof that, when extracted from the mine, the fire clay and shale are in such a state that they are ready for industrial use or consumption—in short, they have passed the "mining" state on which the depletion principles operates. It would be strange, indeed, to ascribe to the Congress an intent to permit each miner to adopt processes peculiar to his individual operation. Depletion, as we have said, is an allowance for the exhaustion of capital assets. It is not a subsidy to manufacturers or the high-cost mine operator. The value of respondent's vitrified clay products, obtained by expensive manufacturing processes, bears little relation to the value of its minerals. The question in depletion is what allowance is necessary to permit tax-free recovery of the capital value of the minerals.

Respondent insists that its miner-manufacturer status makes some difference. We think not. It is true that the integrated miners in Indiana outnumbered the nonintegrated ones. But in each of the three basic percentage depletion Acts the Congress indicated that integrated operators should not receive preferred treatment. Furthermore, in Regulation 77, discussed above, the Treasury specifically provided that depletion was allowable only on the crude mineral product. And, as we have said, this regulation was substantially enacted into the 1943 Act. We need not tarry to deal with any differences which are said to have existed in administrative interpretation, for here we have authoritative congressional action itself. Ever since the first percentage depletion statute, the cut-off point where "gross income from mining" stopped has been the same, *i. e.*, where the ordinary miner shipped the product of his mine. Respondent's formula would not only give it a preference over the ordinary nonintegrated miner, but also would grant it a decided competitive advantage over its nonintegrated manufacturer competitor. Congress never intended that depletion create such a discriminatory situation. As we see it, the miner-manufacturer is but selling to himself the crude mineral that he mines, insofar as the depletion allowance is concerned.

IV.

We now reach what "ordinary treatment processes" are available to respondent under the statute. As the principal industry witness put it at hearings before the Congress: "Obviously it was not the intent of Congress that those processes which would take your products and make them into different products having very different uses should be considered, as the basis for deple-

tion."[9] But respondent says that the processes it uses are the ordinary ones applied in the industry. As to the miner-manufacturer, that is true. But they are not the "ordinary" normal ones applied by the nonintegrated miner. It was he whom the Congress made the object of the allowance. The fabrication processes used by respondent in manufacturing sewer pipe would not be employed by the run-of-the-mill miner—only an integrated miner-manufacturer would have occasion to use them.

Respondent further contends, however, that it must utilize these processes in order to obtain a "commercially marketable mineral product or products." It points out that its underground method of mining prevents it from selling its raw fire clay and shale. This position leads to the conclusion that respondent's mineral product has no value to it in the ground. If this be true, then there could be no depletion. One cannot deplete nothing. On the other hand, respondent alleges that its minerals "yield the best sewer pipe which is made in Indiana." If this be true, then respondent's problem is one purely of cost of recovery, an item which, as we have said, has nothing to do with value in the depletion formulae. Depletion, as we read the legislative history, was designed not to recompense for costs of recovery but for exhaustion of mineral assets alone. If it were extended as respondent asks, the miner-manufacturer would enjoy, in addition to a depletion allowance on his minerals, a similar allowance on his manufacturing costs, including depreciation on his manufacturing plant, machinery and facilities. Nor do we read the use by the Congress of the plural word "products" in the "commercially marketable" phrase as indicating that normal processing techniques might include the fabrication of different products from the

[9] Robert M. Searls, Attorney, San Francisco. Silver Subcommittee Hearings, 1942, p. 764.

same mineral. We believe that the Congress was only recognizing that in mining operations often more than one mineral product was recovered in its raw state.

In view of the finding that substantial quantities—in fact, the majority—of the tonnage production of fire clay and shale were sold in their raw state, we believe that respondent's mining activity during the year in question would come under clause (iii) of the section here involved. That clause includes "minerals which are customarily sold in the form of a crude mineral product." We believe that the Congress intended integrated mining-manufacturing operations to be treated as if the operator were selling the mineral mined to himself for fabrication. It would, of course, be permissible for such an operator to calculate his "gross income from mining" at the point where "ordinary" miners—not integrated—disposed of their product. All processes used by the nonintegrated miner before shipping the raw fire clay and shale would under such a formula be available to the integrated miner-manufacturer to the same extent but no more.

Nor do we believe that the District Court and Court of Appeals cases involving percentage depletion and cited by respondent are apposite here.[10] We do not, however, indi-

[10] Respondent's cases are based on *United States* v. *Cherokee Brick & Tile Co.*, 218 F. 2d 424 (adhered to in *United States* v. *Merry Bros. Brick & Tile Co.*, 242 F. 2d 708), which went off on factual concessions not present here. They have been pyramided into a statistically imposing number of cases, predicated upon one another. Close analysis indicates that they either go off on concessions or findings not present here, or deal with controversies over particular treatment processes claimed as "ordinary" in the industry involved. For our purposes, we need not reach the question of whether in those cases the minerals in place had any "value" to be depleted. Other than the decision here under review, only two of the Court of Appeals cases cited by respondent, both from the same Circuit (*Commissioner* v. *Iowa Limestone Co.*, 269 F. 2d 398; *Bookwalter* v. *Centropolis Crusher Co.*, 272 F. 2d 391), adopt the profitability test, which we find unacceptable.

cate any approval of their holdings. It is sufficient to say that on their facts they are all distinguishable.

In view of these considerations, neither of respondent's alternate claims for depletion allowance is appropriate. The judgment of the Court of Appeals is therefore reversed, and the cause remanded for further proceedings in conformity with this opinion.

It is so ordered.

SUPREME COURT OF THE UNITED STATES

No. 513.—October Term, 1959.

United States of America, Petitioner, *v.* Cannelton Sewer Pipe Company.	On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit.

[June 27, 1960.]

Mr. Justice Harlan, concurring in the result.

In joining the judgment in this case I shall refer only to one matter which, among the voluminous data presented by the parties, is for me by far the most telling in favor of the Government's position.

Treasury Regulation 77, promulgated in 1933 under the Revenue Act of 1932 (47 Stat. 169), defined the basic term "gross income from the property" contained in § 114 (b)(4) of the 1932 Act and carried forward in its successors. Art. 221 (g). It concededly supports, by its express terms (see *ante*, p. ——), the position of the Government in the present case. In my opinion the regulation was undoubtedly a valid exercise of the Commissioner's power to construe a generally worded statute. See Preliminary Report on Depletion, Staff Reports to the Joint Committee on Internal Revenue Taxation (1930), p. 68 (Shepherd Report); *Helvering* v. *Wilshire Oil Co.*, 308 U. S. 90, 102–103. The Revenue Act of 1943 (58 Stat. 21, 45), which added to the 1939 Code the provisions governing this case, represented only a limited departure from the 1933 Regulation, or from the administrative action taken under it, principally in the area of extractive processes applied to minerals not customarily sold in the form of a crude product, and did not basically affect the meaning of the term "gross income from the property." See, *e. g.*, Revenue Act of 1943, Hearings

before the Senate Committee on Finance, 78th Cong., 1st Sess., on H. R. 3687, pp. 527–529; S. Rep. No. 627, 78th Cong., 1st Sess., pp. 23–24; Revenue Revision of 1942, Hearings before the House Committee on Ways and Means, 77th Cong., 2d Sess., p. 1202; compare *id.*, at 1199; Silver, Hearings before the Senate Special Committee on the Investigation of Silver, 77th Cong., 2d Sess., pursuant to S. Res. No. 187 (74th Cong.), pp. 761–764. Respondent's efforts to impugn the force of that regulation, see Shepherd Report, *supra*, at 70, 71; Revenue Revisions, 1947–1948, Hearings before the House Committee on Ways and Means, 80th Cong., 1st Sess., p. 3283; Mineral Treatment Processes for Percentage Depletion Purposes, Hearings before the House Committee on Ways and Means, 86th Cong., 1st Sess., pp. 258, 264, seem to me quite unpersuasive.

This history, in my view, provides an authoritative and controlling gloss upon the term "commercially marketable mineral product or products" in the statutory definition of "mining," which in turn constitutes the "property" with which the statute deals. See *Helvering* v. *Wilshire Oil Co.*, *supra*. It results, on this record, in limiting respondent's basis for depletion to its constructive income from raw fire clay and shale.